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¶I. Key Objectives and Priorities

(SBU) The UK strongly supports the calling of the G20 November 15 Summit, and favors a general statement of principles as the Summit's outcome (ref c). HMG would hope that the discussion of principles would include those identified by Prime Minister Brown in his seven-page document "An International Programme for Strengthening The Global Financial System", which he presented at the October 15-16 EU Council Meeting. Those principles include: transparency, in relation to risks and balance sheets; integrity, and the absence of conflicts of interest in the system; responsibility of management for the risks they undertake sound banking practices, with respect to risk and capital adequacy; and coordination across borders in recognition of global markets. HMG also supports the creation of one or more working groups to develop proposals for consideration at future G20 meetings.

(SBU) Prime Minister Brown has not declared what his aspirations are for the Summit, but we expect that he and Chancellor of the Exchequer Darling will want to discuss a new international financial architecture, which has long been favored by Brown. The PM has said publicly in a speech before business leaders on October 27 that there needed to be a new international monetary system with an early warning system, a crisis prevention system and a proper surveillance system. In response to a question, the PM said the purpose of the November 15 meeting is set up the machinery by which agreements can be reached on the management of the international economy and of the standards for financial institutions. Darling, in a major policy speech on October 29th, called for new "international financial institutions that are fit for our times, that can prevent another global financial crisis and which foster cooperation as a first, rather than last, resort." He also called for new international lending facilities at the IMF and the European Union to provide emergency, temporary lending, particularly to emerging markets. Trade Secretary Gareth Thomas, at a business roundtable on October 30, indicated that HMG also hopes that there will be a declaration to reinvigorate the Doha Trade Round at the November 15 meeting.

II. Key Concerns

In regards to the UK itself, HMG is primarily concerned about ensuring adequate liquidity in the short term, making new

capital available to banks, allowing them to restructure their finances while continuing to provide support to the real economy, ensuring the banking system has the funds necessary to maintain lending in the medium term, and insuring bank deposits to head off any repeat of the run on Northern Rock. With the UK sliding into recession, HMG is increasingly concerned about the effects of the global crisis on the real economy (see response to question IV). The UK economy relies heavily on the construction and financial services industries that are particularly vulnerable in the current crisis. The recent volatility of the pound sterling vis--vis the dollar and the Euro is also of heightened concern.

III. Impact of the Financial Market Crisis on the Financial Sector
IV. Actions Taken to Address the Financial Crisis

Two banks have failed, Northern Rock and Bradford and Bingley. Several other banks have been severely affected by the crisis, including Abbey, Barclays, HBOS, HSBC, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland and Standard Chartered.

HMG has agreed to inject GBP 37 billion into three banks: Royal Bank of Scotland (RBS), Lloyds TSB and HBOS (refs e and f). The government will own a majority stake, up to 70 percent in RBS, and more than 40 percent in Lloyds and HBOS. The three banks have suspended dividend payments on ordinary shares until they fully repay the GBP 9 billion in preference shares issued by the government. The banks will face restrictions on executive pay and have agreed to pay their

2008 executive bonuses in shares. HMG has increased deposit insurance to GBP 50,000, and has also prohibited short-selling of stocks, on a trial period that ends on January 31, 2009. Barclays and HSBC have decided not to participate in the government scheme. Barclays is raising GPB 7.3 billion by selling securities to the Qatar Investment Authority, the Challenger investment vehicle owned by the Qatari royal family, and Sheik Mansour Bin Zayed Al Nayan of the Abu Dhabi royal family. HSBC received a GBP 750 million capital injection from HSBC Holdings PLC, its international parent company.

PM Brown told the House of Commons on October 20 that HMG will increase borrowing to support the economy. Despite public finances reaching a record deficit in the first six months of the financial year (which begins in April), HMG will support mortgage holders, small firms and employees through "carefully targeted, rigorously worked through investments." HMG will also bring forward construction projects on schools and hospitals.

¶V. Current Economic Situation/Near-Term Outlook

The UK economy is likely to be entering a recession, according to the BOE (refs b,c). GDP growth was negative 0.5 percent in the third quarter. The credit crunch, combined with a fall in real disposable incomes, poses the risk of a prolonged slowdown in domestic demand. The UK's GDP is expected to shrink by 1 percent next year, followed by a modest recovery in 2010 with GDP growth of 1 percent. If these predictions hold true, 2009 will be the first full year of shrinking output since the last recession in 1991, when output fell by 1.4 percent over the year prior.

Inflation has jumped to 5.2 percent in September, above the BOE expected 5 percent rate and significantly above the two percent target rate. Surging household utility and food prices were the key factors behind this jump. The declining price in oil is expected to bring inflation down below the five percent mark in October, but inflation will remain a significant concern. In September, unemployment recorded its biggest rise in 17 years, jumping by 164,000 workers to 1.79

million, the largest rise since 1991. The weakening global economy is also affecting the UK's trade deficit. Although it narrowed slightly in August to GBP 4.7 billion from GBP 4.8 billion, the gap was GBP one billion higher than analysts had expected.

The effects on the real economy have also become evident: car sales were down 21 percent in September alone and house repossessions are set to rise by 50 percent to 45,000 this year. The Chartered Institute of Purchasing and Supply's (CIPS) index dropped to 46 from 49.2 in September, the largest ever drop since recording began in 1996, and the fifth straight month of decline. (A reading below 50 signals service industry contraction). The Federation of Small Businesses reported that the credit crunch is closing 27 pubs a week and 40 businesses per day across the UK. The near future remains bleak, according to the Ernst and Young ITEM Club Q3 report, which predicts the consumer economy will collapse by the end of the year and will not edge toward positive territory until late 2010 before staging a "feeble" recovery of 1.9% growth in 2011. House prices have declined 15% and many predict a total decline of as much as 30%.

Embassy Point of Contact

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